BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
SAGA CORPORATION)

For Appellants: Blakeney Stafford
Fred Chilton
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For Respondent: Claudia K. Land
Counsel

O P I N I O N

This appeal is made pursuant to section 25666 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of Saga Corporation against proposed assessments of additional franchise tax in the amounts of $17,320.39, $50,917.16, $52,406.05, $94,415.22, and $268.09 for the income years ended June 30, 1970, June 30, 1971, June 30, 1972, June 30, 1973, and June 30, 1975, respectively.

Appeal of Saga Corporation

The question presented by this appeal is whether College Housing, Incorporated (CHT) and Scope Associates (Scope), a partnership, were part of appellant's unitary business.

Appellant (hereinafter sometimes referred to as Saga) is a New York corporation which has been doing business in California since 1958. It originally provided food service only to colleges and universities, and during the years at issue this activity still provided the greatest share of appellant's revenue. During the appeal ye-ars, however, appellant was expanding its operations, providing food service to hospitals, businesscs, and industry and acquiring several restaurant chains. Its operations were conducted through a number of subsidiaries throughout the United States.

Saga was one of the three original incorporators of CHI, a California corporation, and from 1967 on it owned 50.51 percent of CHI's stock. CHI was primarily involved in the development, design, financing, and management of off-campus student dining and housing facilities in California and other states. At each of the several off-campus dormitories which CHI operated, a Saga subsidiary provided the food service. In 1968, appellant purchased Oxford, a dormitory complex in Davis, California, which it leased to CHI. CHI managed and operated Oxford and a Saga subsidiary provided the food service. Due to continuing losses, CHI's operations were terminated in 1971 and taken over by appellant.. Eventually, these activities became part of Saga Enterprises, Inc. (SEI), a wholly-owned subsidiary of. appellant.

Appellant, CHI, and two of appellant's officers were among the original partners of Scope in 1965. The partnership purchased land near Cal. ifornia State University at Sacramento and in 1966 built a student housing and dining complex (Westbridge). CHI managed the facilities and a Saga subsidiary provided the fiood service. CHI (until termination of its operations) maintained a 10 percent. interest in Scope, while appellant's interest in the partnership increased from. 23.1 percent in 1965 to 71.9 percent in 1970 and to 100 percent. in 1972.

For the income years ended June 30, 1970, 1971, 1972, 1973, and 1975, appellant's franchise tax returns were filed on the basis of a combined report, using the standard three-factor apportionment formula

to determine the amount of its business income subject to tax in California. All of appellant's food service and restaurant subsidiaries were included in the combined report, but CHI was omitted. Appellant also reported its distributive share of Scope's income as nonbusiness income rather than as apportionable business income.

Respondent examined appellant's and CHI's returns for the income years on appeal and determined that CH-I was part of appellant's unitary business and should have been included in appellant's combined report. It also determined that Scope was part of the unitary business, and appellant's and CHI's shares of Scope's income and apportionment factors should have been included in the combined report as well.

Proposed assessments were issued reflecting these determinations. Appellant protested, a hearing was held, and respondent affirmed the proposed assessment. This timely appeal followed.

I. CHI

During the years in question, appellant owned 50.51 percent of CHI. In 1970 and 197.1, three of appellant's directors were directors of CHI. One of these also served as CHI's secretary. In late 1970, appellant's executive vice-president (who was also president of SEI and a director of CHI) became the president of CHI, replacing its previous president, Mr. Swift. Mr. Swift had originally been hired as general manager of CHI by the chairman of appellant's board of directors. While he was president of CHI, Mr. Swift also apparently functioned as an executive vice-president of appellant. Appellant contends that Mr. Swift's operation of CHI was not subject to Saga's control, although minutes of the Saga board of directors' meetings discuss financing and policy for CHI and mention reports made to Saga by Mr. Swift.

From 1969 through 1971, appellant made loans and extended a line of credit to CHI. In 1970, Saga made a $1,000,000 loan to CHI at a time when the latter was unable to obtain bank credit and the other CHI *shareholders* were unwilling to provide any money for working capital.

CHI and Saga used different accounting, legal, and insurance services, at least until Saga took over CHI's operations in 1971. Only two of CHI's more than

one hundred employees.came from Saga, and only after Saga took over CHI's operations did it employ any of CHI's personnel. CHI contracted exclusively with Saga subsidiaries to provide food services for all the facilities it managed, including Oxford and Westbridge. Although CHI rented one floor of Saga's headquarters in Menlo Park, California, it apparently maintained a separate switchboard, mail service, and accounting department there.

When a taxpayer derives income from sources both within and without this state, its franchise tax is measured by the amount of net income derived from or attributable to sources within this state. (Rev. and Tax. Code, § 25101.) If the taxpayer is engaged in a unitary business with affiliated corporations, the income attributable to California sources must be determined by applying an apportionment formula to the total income derived from the combined unitary operations of the affiliated companies. (Edison California Stores, Inc. v. McColgan, 30 Cal.2d 472 [183 P.2d 16] (1947); John Deere Plow Co. v. Franchise Tax Board, 38 Cal.2d 214 [238 P.2d 569] (1951), app. dism., 343 U.S. 939 [96 L.Ed. 1345] (1952).)

The California Supreme Court has.set forth two alternative tests for determining whether a business is unitary. In Butler Brothers v. McColgan, 17 Cal.2d 664 [111 P.2d 334] (1941), affd., 315 U.S. 501 [86 L.Ed. 991] (1942), the court held that the existence of a unitary business was definitely established by the presence of the three unities of ownership, operation, and use. Later, in Edison California StoresInc. v. McColgan, supra, the court said that a business is unitary-if-the operation of the business done within this state depends upon or contributes to the operation of the business outside the state. Subsequent cases have affirmed these tests and given them broad application. (Superior Oil co. v. Franchise Tax Board, 60 Cal.2d 406 [34 Cal.Rptr. 545] (1963); Honolulu Oil Co. v. Franchise Tax Board, 60 Cal.2d 417 [34 Cal.Rptr. 552] (1963).)

In support of its position that CHI was not a part of the unitary business, appellant argues that unity of ownership was minimal, with no real control of CHI by appellant, and that the unities of use and operation were lacking. It also contends that CHI's business was too different from Saga's unitary business for any contribution or dependency to exist between them, We find, however, that Saga and CHI were engaged

in a unitary business under the contribution or dependency test of Edison California Stores, Inc. v. McColgan, 30 Cal. 2d 472 (1947), supra.

We have held that, in the case of affiliated corporations, both of the unitary tests require controlling ownership. (Appeal of Revere Copper and Brass, Incorporated, Cal. St. Bd. of Equal., July 26, 1977.) Controlling ownership does not require 100 percent stock ownership, but simply common ownership, directly or indirectly, of more than 50 percent of a corporation's voting stock. (Appeal of Revere Copper and Brass, Incorporated, supra.) That standard is met in this case.

Appellant, however, contends that Saga did not actually control CHI, so unity of ownership should not be found to have existed. In support of its position, appellant refers us to Appeal of Signal Oil and Gas Company, etc., decided by this board September 14, 1970, Appeal of Standard Brands Incorporated, decided October 18, 1977, and Appeal of Revere Copper and Brass, Incorporated, supra. These cases are inapposite since in each the parent corporation owned exactly 50 percent of the subsidiary's stock and the taxpayers were attempting to show controlling ownership without more than 50 percent stock ownership. Although we did find controlling ownership in Signal Oil, supra,, based on certain operating agreements under which one of the 50 percent shareholders was clearly given effective control, the converse of this rationale has never been applied to negate unity of ownership where more than 50 percent ownership existed. Even if we were to use such a rationale, appellant has not shown any agreement similar to that in Signal Oil which would indicate that Saga did not have controlling ownership. To the contrary, as we point out more specifically below, the record indicates that Saga did have effective control over CHI. Therefore, the requisite unity of ownership is present.

Appellant contends that CHI and Saga were engaged in "radically different businesses" and therefore much stronger evidence of actual contribution or dependency must be demonstrated than would be the case if the businesses were similar. We disagree both with the implication that respondent, rather than appellant, bears the burden of proof (see Appeal of John Deere Plow Company of Moline, Cal. St. Bd. of Equal., Dec. 13,

1961), and with the contention that CHI and Saga were engaged in completely unrelated businesses. 1/

Although the activities engaged in by Saga' and CHI were different, their complementary operations made them very similar to a vertically integrated business. CHI developed and managed dormitories in several states. Appellant's subsidiaries provided all the food services for all of these facilities. The offering of food service in the dining halls it managed was an integral part of CHI's management responsibility. Providing food service to college and university dormitories was a major part of appellant's activities and its major source of income.

The allegation-of dissimilarity between CHI's activities and those of appellant is also contradicted by evidence in the minutes of appellant's board of directors' meetings. It appears that Saga itself had been requested by colleges to build or finance dormitories' and dining facilities and had provided consulting services for the construction and design of dormitory-related dining halls'. Saga had provided these and related services in order to procure or retain food service contracts with colleges. With CHI, Saga had the ability to channel such requests to' an organization which could **also** provide construction and management services and still assure Saga that it would procure or retain the food service contracts. The mutual benefits of such an arrangement are obvious, and constitute the type of contribution and interdependence characteristic of a unitary business.

In addition to the basic integration just described, several other important unitary features are present which indicate that interdependence and contribution existed between CHI and appellant's unitary business. Chief among these are an integrated executive force, intercompany loans, and intercompany product flow.

1/ See Appeal of Hollywood Film Enterprises, Inc., Cal.. St. Bd. of Equal., March 31, 1982, for a discussion of the burden of proof in a case involving "different businesses." As we pointed out in that appeal, there is no separate test or heavier burden of proof imposed in such a case.

An integrated executive force was called "an element of exceeding importance" in determining unity by the court in Chase Brass & Copper Co. v. Franchise Tax Board, 10 Cal.App.3d 496 [87 Cal.Rptr. 239] (1970). An integrated executive force existed between CHI and Saga through interlocking directors and officers. Half of CHI's directors during 1970 and 1971 were also directors of Saga and one of these was also the secretary of CHI. In late 1970, one of the directors of both CHI and Saga became CHI's president.

Appellant contends that Mr. Swift, president of CHI until late 1970, operated the company completely independently, as a "one-man show." Although this appears to be true as to the day-to--day operations, meeting minutes reveal that Saga's board of directors made the major policy decisions regarding CHI's activities and did so in the context of CHI's position as an integral part of Saga's entire business organization. In this regard, the court in Chase Brass, supra, stated:

> The "major policy matters" are what count in our estimation of integration. Day-to-day operations are made at various levels by many executives in any organization. They are made; no doubt, by a multitude of officials of Kennecott [the parent corporation] and its subsidiaries. Major policy is another thing. This was the concern of Kennecott. (Chase Brass & Copper Co. v. Franchise Tax Board, supra, 10 Cal.App.3d at 504.)

Saga's board and officers apparently had the expertise necessary to make these decisions for CHI, since, as was previously mentioned, they were already well acquainted with the needs and requirements of college dormitory and dining facilities. 2/

2/ This situation is in contrast to that of Appeal of Hollywood Film Enterprises, Inc., supra, where the executive assistance provided was on the most general level, going more toward the development of the subsidiary's own independent business activities, and where the parent's executives apparently had little expertise in the conduct and techniques of the subsidiary's business.

Another important indicator of unity present in this appeal is the ability of the subsidiary to turn to its parent for necessary financing when funds were unavailable to it from other sources. (Appeal of I-T-E Circuit Breaker Company, Cal. St. Bd. of Equal., Sept. -23, 1974.) Appellant provided CHI with loans or lines of credit of up to $1,500,000 during 1970 and 1971. Because commercial credit was unavailable and the other CNI shareholders were unwilling to provide needed funds, CHI apparently continued as a separate corporation for as long as it did only because appellant supplied financial support. When this was no longer feasible because of CHI's continued losses, its operations were taken over by Saga.

Substantial intercompany product flow is also significant evidence of unity. (See, e.g., Appeal of Grolier Society, Inc., Cal. St. of Rd. of Equal., Aug. 19, 1975; Appeal of I-T-E Circuit Breaker Company, supra; Appeal of Swift & Company, Cal. St. Bd. of Equal., April 7, 1970.) Although appellant had no manufactured product which it might sell, its food services can be considered its product, and there was a substantial intercompany flow of these services. Appellant contends that CHI's purchases of food from Saga subsidiaries constituted extremely small percentages (.22% in fiscal 1970 and .11% in fiscal 1971) of Saga's total food sales. Appellant does not reveal the percentages of their total food service sales made by each of the supplying subsidiaries to CHI. Nevertheless, the food services supplie'd to CHI constituted 13.98 percent and 7.98 percent of its total expenses for 1970 and 1971, respectively. Most importantly, Saga provided 100 percent of the food services for the facilities which CHI managed. We find this to be significant evidence of the interrelationship of the two companies.

Appellant contends that these factors lack "quantitative substantiality." In the Appeal of Scholl, Inc., after describing the two tests for unity, we stated:

> Implicit in either test, of course, is the requirement of quantitative substantiality. [Citations.] In other words, corporations are engaged in a unitary business within the scope of either test if, because of the unitary features, the earnings of the group are materially different from what they would have been if each corporation had operated without the benefit of its unitary connections with the other corporations. (Appeal of Scholl, Inc., Cal. St. Rd. of Equal., Sept. 27, 1978.)

Appellant seems to interpret the language quoted above to require that respondent prove a discrete and measurable earnings increase from each corporation in the group. This is incorrect for at least two reasons. First, as we indicated previously, appellant rather than respondent bears the burden of proof, i.e., appellant must establish by a preponderance of the evidence that the unitary connections present in this case are, in the aggregate, so trivial and insubstantial as to require a holding that a single unitary business did not exist. 3/ Second, a discrete and measurable earnings increase from each corporation in the group is not necessary. Appellant's interpretation was rejected in the early case of Butler Brothers v. McColgan, supra. There the taxpayer argued that the economies of quantity purchasing for the group would not he affected if the California sales were eliminated and thus urged that the California store made no contribution to those savings. The California Supreme Court refuted this sophistic argument by pointing out that taking each store in turn one could make the same contention and show that none of the sales in any of the states contributed to the savings resulting from quantity purchasing. The court emphasized that it was the aggregate effect of the interdependent sales activities which determined whether there was unity among all the stores.

3/ "Quantitative substantiality" does not shift the burden of proof to respondent. Although the substantiality of the unitary connections was discussed in Scholl, supra, and in the recent Appeal of Daniel Industries, Inc., decided June 30, 1980, in terms of what the respondent proved or did not prove, that was only because the appellants in those cases had produced sufficient credible evidence to negate the existence or the significance of the unitary connections upon which respondent relied and to overcome the presumptive correctness of the respondent's determinations. The burden of going forward with the evidence, therefore, shifted to the respondent. (9 Mertens, Law of Federal Income Taxation, § 50.61 (1977 Revision).) The burden of proof or persuasion, however, remained on the appellants. (9 Mertens, supra, § 50.51 (Jan. 1982 Cum. Supp.).) Weighing the evidence presented by each side in those appeals, in each case the appellant carried its burden of persuasion by a preponderance of the evidence.

The 'concept of "quantitative substantiality" merely distinguishes between those cases in which unitary labels are applied to transactions and circumstances which, upon examination, have no real substance, and those in which the factors involved show such a significant interrelationship among the related entities that they all must be considered to be parts of a single integrated economic enterprise. Each case must be decided on its own particular facts; where, as here, the taxpayer is contesting respondent's determination of unity, it must prove by a preponderance of the evidence that, in the aggregate, the unitary connections relied on by respondent.are so lacking in substance as to compel the conclusion that a single integrated economic enterprise did not exist.

We are are persuaded that the unitary connections between CHI and Saga were not merely superficial or trivial. In light of the substantial interrelationship of the two companies, the elements of independence and separateness emphasized by appellant are inconsequential.. Saga's unitary business and CHI were not truly "separate and distinct," but operated with such mutual contribution and interdependence that respondent's determination of unity between the two must be sustained.

II. Scope

The Scope partnership owned and constructed the Westbridge dormitory complex which CHI leased and operated and for which Saga provided food services. Appellant contends that Scope's activities were not part of appellant's unitary business and none of the income from Scope shou'ld be included in apportionable business income.

Appellant first argues that our decisions in Appeal of Custom Component Switches, Inc., decided February 3, 1977 and Appeal of H. F. Ahmanson & Company, decided April 25, 1965, "stand for the proposition that no part of a partnership's property is combined with the property of any related entity in order to apportion the combined income of the partnership and such entity." However, as appellant admits, unitary treatment was not an issue in those appeals. They dealt solely with the source of a partnership's income, and thus do not support appellant's interpretation.

Unitary treatment of a partnership and a corporate partner, based upon either of the two general

tests for unity, was clearly established in Appeal of Pup 'N' Taco Dr-ive Up, Order Denying Petition for Rehearing and Substituting Opinion, Cal. St. Bd. of Equal., Jan. 11, 1978. In the present appeal, we find that unitary treatment is warranted by the substantial contribution and dependency which existed between Scope and the unitary business.

Appellant mentions, without discussing, the issue of whether "a corporation is required to own more than 50 percent of a partnership before the corporation's share of partnership income and apportionment factors may be included in a combined report. The same issue was raised, but not decided, in Appeal of Pup 'N' Taco Drive Up, supra. It arises here only with respect to the inclusion of CHI's share of Scope, since Saga clearly met any ownership requirement. In this appeal, as in Pup 'N' Taco, respondent argues that unity of ownership exists per se between a corporation and a partnership to the extent of the corporation's actual ownership interest in the partnership. In support of this position, respondent points out that a partnership is not a separate taxable entity and that the partnership income and apportionment factors are included in the combined report only to the extent of the corporate partner's actual ownership interest.

We find respondent's argument convincing. The same position is reflected in respondent's regulation 25137, subdivision (e), filed November 15, 1974. (Cal.. Admin. Code, tit. 18, reg. 25137, subd. (e).) Although this regulation may not be controlling for earlier years (see Appeal of Pup 'N' Taco Drive Up; supra), the rationale is compelling, and for the sake of consistency and uniformity under the Uniform Division of Income for Tax Purposes Act (UDITPA), we believe that respondent's theory should be used in apportioning and allocating partnership income for the years to which UDITPA is applicable., There-fore, Saga's and CHI's shares of the partnership items must be included in the combined report if Scope is otherwise found to be part of the unitary business.

Appellant states that the businesses of Scope and Saga were radically dissirnilar and there was no actual, significant contribution to or dependence upon one another. It concludes that Scope was clearly not unitary with Saga. This assertion, however, does nothing to refute the contribution and dependency apparent in the functional integration of Scope with the unitary

business. Saga made loans to Scope at various times. Scope owned the land and buildings which were leased and operated by CHI. A Saga subsidiary provided food service for the facilities. Through Scope, the unitary business not only had a guaranteed market for its services, but also was able to keep additional income within the group. This is unquestionably a relationship requiring unitary treatment and we find, therefore, that Saga's and CHI's distributive shares of Scope's income and apportionment factors should be included in the combined report.

Other issues originally raised by appellant are either resolved by our present decision or have apparently been abandoned. For the reasons stated above, we sustain respondent's action.

O R D E R

Pursuant to the views expressed in the opinion of the board on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to section 25667 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protest of Saga Corporation against proposed assessments of additional franchise tax in the amounts of $17,320.39, $50,917.16, $52,406.05, $94,415.22, and $268.09 for the income years ended June 30, 1970, June 30, 1971, June 30, 1972, June 30, 1973, and June 30, 1975, respectively, be and the same is hereby sustained.

Done at Sacramento, California, this 29th day of June , 1982, by the State Board of Equalization, with Board Members Mr. Bennett, Mr. Dronenburg and Mr. Nevins present

William M. Bennett, Chairman

Ernest J. Dronenburg, Jr., Member

Richard Nevins, Member

, Member

, Member